A comparison of equity crowdfunding in four countries

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A Comparison of Equity Crowdfunding in Four Countries: Implications for Business Angels[1]

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Short title: Equity crowdfunding

Main message

Equity crowdfunding as a rapidly growing source of finance for new and growing entrepreneurial ventures poses new challenges for financial regulators and potentially disrupts the early stage risk capital market and its existing actors, notably business angels.

Key points

Equity crowdfunding responds primarily to the needs of small start-ups that do not manage to access bank finance, or who do not need the larger sums available from venture capital or business angels.

It is not appropriate for firms where business information is too sensitive to be shared with a large number of potential investors, nor those which require substantial amounts of follow on financing.

Within these parameters and with sensible policy implementation and regulation, equity crowdfunding can play a useful complement to the role of business angels in innovation finance as an alternative form of start-up and growth capital.

Introduction

Equity crowdfunding is a method of funding where entrepreneurs seek financing from many individuals in exchange for shares in the firm. It differs from other forms of crowdfunding in that it involves the sale of a security (Harrison 2013), offering a financial return to funders (Belleflamme et al 2013), through an open call for funding on internet based platforms (Ahlers et

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al 2015). These platforms primarily target small investors and provide both the legal base and the ability to process the financial transactions (Decarre and Wetterhag, 2014). They receive applications from entrepreneurs who want to showcase their business idea and, typically after a background check, host the entrepreneur's pitch to potential investors. If the funding goal is reached (in the "all or nothing" model), the funds are distributed to the project owner, otherwise they are returned to investors. As business models in the sector continue to evolve, some international platforms offer a profit sharing type of crowdfunding, with a VC type structure: investors pool fees in a community investment fund run by the platform which invests in particular entrepreneurial projects. These are held for a few years after which the platform takes a 20-25 per cent share of the profits and distributes the remainder.

Like other forms of crowdfunding, this model has a number of potential benefits for start-ups. It enables them to test and build a market and gives them access to a large pool of investors. Unfortunately, it also has potential costs: reputation effects if campaign goals are not met; IP exposure; investor exhaustion; and the time required to "work the crowd". The up-front costs are not small either. Over and above the required accountant fees, UK platforms in 2013 charged between 5 per cent and 12 per cent, often with a further 3 per cent-5 per cent processing fee (compared with typical angel group charges of 5 per cent of cash raised plus a 1 per cent warrant[3]). These costs suggest that crowdfunding may not be the answer for every entrepreneur. Crowdfunding also has implications for business angels. Should it be viewed as useful complement to angel investing? Or a problematic new development that could jeopardize recent strides in seed investing? It is therefore important to prevent an over enthusiastic response from unaware investors, and in due course, regulators.

Literature Review

There is a small (albeit growing) number of articles on equity crowdfunding, a result of the short time period of available data (Baeck et al, 2014; Collins and Pierrakis, 2012). Research from the UK is arguably the most developed, as it was one the first countries to give regulatory approval and has the fastest growing market (Wardrop et al. 2015; and Bruton et al. 2015).

Most articles attempt to develop investor and firm profiles, particularly those considered "successful". Platforms catering to equity crowdfunding form only about 7.3 per cent of the total number of worldwide platforms (Cumming and Johan, 2013). The average amount of money collected per campaign is about $190,000 (Massolution, 2013) and the majority of firms seeking funding are between one and three years old. A further 28 per cent are established four to eight year old small firms and 15 per cent are start-ups with no revenue yet (Knowledge Peers, 2013). The average campaign lasts around eight weeks (De Buysere et al. 2012). Worldwide, it is estimated that US$1.1 billion was raised in equity crowdfunding in 2014 (compared with US$11.08 billion in peer-to-peer lending and $6.1 billion in other forms of crowdfunding)

[3] John Waddell, personal communication, February 2016.

(Massolution, 2015). This remains small in comparison with angel investment of around $24bn in the US (Sohl 2013; CVR 2015) and between £750m and £1bn annually in the UK (Mason et al 2015). However, equity crowdfunding has expanded rapidly, rising in the UK from £1.7m in 2011 to £3.9m in 2012, £28m in 2013, £84m in 2014 and £245m in 2015, almost equaling total venture capital investment (excluding private equity) (Zhang et al 2015). The biggest challenge for the growth of equity crowdfunding has been that in many countries existing fund raising legislation, with its skew towards the protection of investors, has blocked or hindered development of this type of finance (Borg, 2007). This situation is changing, however, as countries change or consider changing their securities legislation to be more equity crowdfunding "friendly" (CAMAC, 2014).

Crowdfunding attracts a few investors who act like business angels, defined as "a private individual, mostly high net worth, usually with business experience, who directly invests part of his or her personal assets in new and growing unquoted businesses." (EBAN, 2014). As such they are normally imbued with a real knowledge of a project's market and product. Most, however, are more interested in projects that share their own values, or are locally engaging (De Buysere et al, 2012). According to Zhang et al (2014), UK equity crowdfunding investors differ considerably from business angels: they are younger (average age 40), smaller scale (average portfolio size below £5500, with one third having invested under £1000), and unsophisticated (only 38 per cent were classified as professional or high net worth investors, and 44 per cent of investors were using money from their savings rather than investment budgets). This is consistent with a recent small-scale study of the demand for equity crowdfunding in Scotland, where six companies raised £619,000 in total from 649 backers [average £950 per investor] for an average equity stake of 17.5 per cent per company [or 0.13 per cent per investor]. Given their lack of specific knowledge, these investors attempt to mitigate risk by using the actions of other crowdfunders as a source of information in their funding decision (Ward and Ramachandran, 2010). In fact, Pierrakis and Collins (2013) show that crowdfunders only spend an average of 15 minutes on due diligence before investing, as opposed to 20 hours for business angels. As the LINC (2014) report notes, this suggests a concerning lack of due diligence, something which is often compounded when firms / governments offer 'sweeteners' to invest, in the form of tax breaks or discounts on products/ services. Given that many equity crowdfunding investors are not experienced investors they require and seek less information upfront and do little if any contract negotiation (Macht and Weatherston, 2014). As small shareholders they have little power over management and may be issued shares with no voting rights (Brown et al 2015). Furthermore, the percentage of equity offered during the crowdfunding process is much lower than that offered to angel investors (Financial Times, 2015), leading to concerns over valuation and likely returns in such deals (de Vasconcelos 2015). Belleflamme and Schwienbacher (2013) also show that *product* drives attract larger amounts of capital than those that offer a *service*, suggesting that the tangibility of products may be more appealing to inexperienced investors. IT entrepreneurs in particular preferred angels who "better understand" complex IT business plans (Ingram and Teigland, 2013). Not unexpectedly firms that disclose financing plans, and have sound boards of directors (with professional curriculum vitae), are more likely to raise more money and do it quickly (Ahlers et al, 2012, Cumming and Johan, 2013).

With respect to outcomes, Decarre and Wetterhag (2014) found that profit growth is positively influenced by offering a larger equity share; the presence of business angels; and early founder investment. Interestingly, the authors found that when business angels were participants, profit growth was an average of 811 per cent higher than if no professional investors had taken part. Of course angels' effectiveness is diluted in a crowdfunded investment, as these lack the alignment of interest and expectation characteristic of angel investments (LINC, 2014). In Ingram and Teigland's (2013) Swedish study, only 17 per cent of equity investors were repeat investors, suggesting that equity crowdfunding is not becoming the investment mechanism choice for many Swedes. (A similar figure was found in a Scottish study, which estimated that about 76 per cent of crowdcube investors were one-time investors (LINC 2014).) Recent UK evidence suggests that while the remits of angel networks and equity crowdfunding platforms remain distinct, there is evidence of angel investors choosing to invest through crowdfunding platforms (British Business Bank, 2014). For example, the Syndicate Room platform has an angel investor as an anchor contribution for a crowdfunding campaign. In fact, some 45 per cent of angels in a recent UK study had invested alongside an equity crowdfunding platform (ERC, 2014). However, other research suggests this figure over-estimates the overlap, suggesting on the basis of a wider sample that 22 per cent of angels have invested through a crowdfunding platform (Mason and Botelho 2014). What is not known is the extent to which their profiles differ from other angels. Are they smaller ticket investors at the lower end of the spectrum of angel investors, or more passive investors?

Entrepreneurs also expressed concern about having a large number of individuals with equity in their companies and the difficulty of coming to consensus on big decisions, or even just "tracking down and convincing lots of individuals to sell if they tried to sell the company later" (Ingram and Teigland, 2013). This is one of the key fears of equity crowdfunding: that "true potential high-growth companies may find themselves cut off from necessary follow-on funding as a result of having taken relatively small initial sums of early-stage funding from large numbers of inexperienced investors" (LINC, 2014: 36). This inability to sell or raise further capital is highlighted in the Decarre and Wetterhag (2014) study. Of the 46 firms that they interviewed: 25 per cent received follow on capital from business angels; 7 per cent from VCs; 13 per cent from another crowdfunding round; 13 per cent from a bank loan; 22 per cent from owner equity; and 24 per cent were not able to raise more funds. (Slightly smaller amounts were achieved from those firms who stated that they had crowdfunded due to lack of other options.) This suggest that an initial crowdfunding success is not an "automatic" stamp of approval in terms of future "fundability".

A recent paper suggests an even more worrying situation in Germany. Of the 86 issues analyzed, only four received follow on financing and 22 underwent some form of insolvency proceeding (Khlon, Hornuf and Schilling, 2015). Together with the public failure of the clean energy developer Prokon, this may have been the impetus for German authorities to limit individual investments to €1,000 in crowdfunded projects (with amounts above this permitted if investors have liquid assets of at least €100,000). In the UK, there have also been calls for greater investor protection after the 2015 failures of Hokkei and Upper Street, which raised UK£320k and UK£243k respectively on Seedrs, and the 2016 collapse of Rebus, which raised over UK£810k from over 100 investors on Crowdcube. This latter case implies an average investment of just over £8000 per investor, somewhat at odds with the wider evidence that crowdfunders invest smaller amounts, and reflecting the highly skewed nature of equity crowdfunding (where campaigns are typically anchored on one or two large investors and backfilled by the crowd).

Suggested investor protection measures include insurance levies and the adoption of a pooled approach as in peer-to-peer funding to mitigate risk (Palin, 2016). Failure, and the implications for regulation and investor protection, is not unusual. Although the UK Crowdcube platform reports that only 6 per cent of over 300 companies raising money through their platform have subsequently failed, other research suggests that one in five companies that raised money on UK equity crowdfunding platforms between 2011 and 2013 in the UK have gone bankrupt (AltFi Data, 2015; Palin, 2016). This is consistent with other UK research that suggests that in 2012 and 2013 the failure rate for crowdfunded companies (21.7 per cent in 2012, 25.4 per cent in 2013) was much higher than for those seed funded from other sources (8.6 per cent, 6.2 per cent). The gap appears much narrower for 2014 fundings however (4.5 per cent vs 3.6 per cent) (Gardiner 2016). These results suggest that in equity crowdfunded businesses failure emerges earlier than in other seed fund businesses, likely due to difficulties in raising follow-on investment.

In summary therefore, crowdfunded investments have fewer knowledgeable investors, less due diligence, lower profit growth, less shareholder control, and less opportunity for follow-on financing than angel investing. The presence of angel investors and investor protection measures can help reduce some of this discrepancy, however. The following section touches on policy attempts at such protection. The article concludes with recommendations on how to address some of the policy gaps.

Policy Comparison

Countries differ quite substantially on how their crowdfunding policy addresses the balance between protecting investors and stimulating innovation. In general, the legislative differences can be summarized by the answers to a number of questions. Do they explicitly regulate crowdfunding? Do platforms, in US parlance, have to register as broker dealers and is there an exemption from payment services legislation with regard to handling funds (do they have to use a third party and/ comply with money laundering regulation)? Are there any capital requirements on platforms? Do firms have to publish a prospectus (with all company details, deadline, amount required, the capital structure, and the valuation)? Do firms have to provide audited financial statements? What risk declarations are required (relating to: minority ownership; corporate actions, possible dilution with additional issuances of shares or a sale of the issuer)? Must platforms perform background checks on issuers? Must platforms enforce annual investor limits? Are projects only funded if the goal is met? Is there a "cooling off" period? What security measures are required to protect investor data? What restrictions on sales of shares exist? Finally, are issuers and funding portals able to advertise *specific* investment opportunities?

In Europe, only six countries have explicit crowdfunding legislation, though a few more have drafts in progress. The European Prospectus Directive (2003/71/EC, amended by 2010/73/EC) allows freedom to national lawmakers to implement a country-specific promotion regime for sub-€5 million offerings, with most countries exempting these firms from having to offer a prospectus. Also, with respect the European Act on Alternative Fund Managers (AIFMD), most countries interpret fund seekers as not falling under the definition of alternative investment funds (AIFs) and platforms as not falling under the definition of alternative investment fund managers (AIFMs). These designations impose a number of additional regulatory requirements on cross border investment fund activity. Legal experts in these countries assume exemption because investment decisions are made by the investor itself and the platform provides a matching service only. Pooling type platforms might be considered AIFMs, however, so the industry is calling for greater clarification from the EU authorities (ECN, 2014).

The United Kingdom

Under current UK legislation, platforms must be registered with Financial Conduct Authority (FCA). To avoid "financial promotion", many engage an FCA-authorized firm to approve initial investor communications and only offer to accredited investors or existing shareholders. This may change though as there is heavy industry pressure for a "lighter touch" regarding promotions, especially those through social media (ECN, 2014). The FCA set out new rules for regulating equity (or investment-based) crowdfunding in March 2014 and reviewed their operation in 2015 (FCA. 2014; 2015). From October 2014, shares and debt securities (non-readily realizable securities) can only be directly offered to retail consumers who take regulated advice, qualify as high net worth or sophisticated investors or confirm they will invest less than 10 per cent of their net assets in this type of security (FCA, 2015). Firms are also required to check whether consumers understand the risks if they do not take regulated advice. In their initial review the FCA identified problems (for the most part rectified following FCA intervention) with most of the UK's equity crowdfunding websites. These include: first, a lack of balance, where many benefits are emphasized without a prominent indication of risk; second, insufficient, omitted or cherry-picking of information, leading to a potentially misleading or unrealistically optimistic impression of the investment; and third, the downplaying of important information, as in risk warnings being diminished by claims that no capital had been lost or the relevant risk warnings being less prominent than performance information (FCA, 2015). This is a matter of concern given that some 62 per cent of equity crowdfunding investors are retail investors with no previous investment experience of early stage or venture capital investment (Zhang et al 2014).

The United States

Title II of the Jump Start Our Business (JOBS) Act allowed for public advertising of fundraising but restricted it to accredited investors. Despite the restrictions, this 'equity crowdfunding' grew by $250 million since the Act was passed. Title III of the JOBS Act came into force in October 2015, legitimizing crowdfunding across the country. It allows people with an annual income or net worth of less than $100,000 to invest 5 per cent of this (or $2,000 if that is greater). Higher income earners can invest up to 10 per cent, but no individual is allowed to invest more than $100,000 per year. Depending on the size, offerings require either an outside accountant's review or a full audit, and issuers have to provide investors with numerous details about their business. The campaign must be conducted through an SEC registered and Financial Industry Regulatory Authority (FINRA) licensed intermediary, either a broker-dealer or a registered funding portal. These platforms must: ensure that investors are aware of risks, take measures to reduce fraud and protect investor privacy, enforce annual investor limits, be all or nothing models, permit cancellation of investment, and not advertise *specific* investment opportunities. There will also be a one year restriction on share transfer unless it is to an accredited investor. (Seventeen states have also enacted separate intra-state Crowdfunding legislation that allows crowdfunding to state residents, some with higher spending caps than the federal bill.)

Canada

In Canada equity crowdfunding is legal under existing prospectus exemptions such as the accredited investor exemption (wealthy individuals that equate to roughly 4 per cent of the Canadian population), and the offering memorandum exemption. The offering memorandum exemption allows firms to sell securities to the public after offering a memorandum to the purchaser (which included audited financial statements) and obtain a signed risk acknowledgement from the purchaser. (Some provinces have a $10000 limit on non-accredited investor investment amounts). The accredited investor exemption has no limits, is subject to certain resale restrictions and requires the filing of documents offered to investors with the relevant Canadian securities regulatory authority and payment of an applicable fee. Currently all portals need to register (as 'exempt market dealers') which permits them to receive or hold investor funds in trust. Registration requires that portals ensure that an investment is a suitable investment for a particular investor. Portals already operating in this manner include: SeedUps Canada, The Funding Portal and Optimize Capital Markets. TSX Private Markets also recently launched its online platform seeking to do private placements and facilitate secondary market trading of securities of private and public issuers, to accredited investors (ECN, 2014). Some provinces are considering licensing specific equity crowdfunding or "start-up" exemptions and Saskatchewan has already legalized the start-up exemption. Manitoba, New Brunswick, Nova Scotia, Ontario, Quebec and Saskatchewan are considering a proposed equity crowdfunding exemption (published for comment on March 2014). All except Ontario are also considering a proposed start- up exemption. The equity crowdfunding exemption would require registration as 'restricted dealer' with fewer regulatory requirements but would not allow portals to accept or handle funds. Firms under these exemptions are required to post audited statements (for reporting firms) or statements reviewed by a CPA. There are holding periods on resale of shares and portals are not allowed to endorse or promote offerings. They must make investors complete an interactive questionnaire or obtain a signed risk acknowledgement form AND certification from investors that they comply with annual investment limits. Background checks need to be done in the proposed equity model. The start-up exemption also precludes holding funds but does not require registration.

Sweden

Sweden's equity platform, FundedByMe has been around for a number of years. Its market is estimated at between €385 and €450 million per year, about the same size as the formal Swedish venture capital market. Platforms in Sweden are considered to be facilitating offerings of securities and as such must obtain a license from the Swedish Financial Supervisory Authority (S-FSA) or co-operate with a licensed firm. Firms looking for less than €2,5m per year are not required to offer a prospectus. A number of organizations offer added incentives. For instance, the Internet Infrastructure Foundation .SE, tops up the amount a crowdfunding entrepreneur receives to 100 per cent if he/she manages to raise 50 per cent or more of the requested amount on the FundedByMe platform (Ingram and Teigland, 2013).

Summary

These country examples represent the early wave of the international growth of crowdfunding and demonstrate, as the International Organization of Securities Commissions (IOSCO) has pointed out, that the national regulators in different jurisdictions have chosen different approaches to regulation (IOSCO, 2014). As the UK regulator makes clear, in developing a proportionate set of rules there is a balance to be struck between the permissive development in the market and the appropriate protection of consumers. The US experience, where the stalled and delayed implementation of the JOBS Act nationally created a void which some states (such as Texas) filled by enacting their own more lenient state-specific rules, has led to a fragmented approach between states, as a result of which platforms find it difficult to prepare a consistent marketing strategy to reach a mass audience. By contrast, and to a large measure building on the UK experience, there is interest in the development of EU-wide regulation designed to reduce or eliminate administrative barriers to cross-border activity, as in the European Securities and Markets Authority (ESMA) mapping of typical equity crowdfunding models onto existing EU legislation (ESMA, 2014).

What runs through these regulatory efforts is an awareness of two sources of risk (ESMA 2015). The first are *project risks.* Many of the key risks in investment-based crowdfunding arise because the majority of projects invested in are smaller companies with a high failure rate and the securities are typically unlisted. This represents a significant potential of capital loss, risk of dilution through subsequent capital raising rounds, limited possibilities for liquidating an investment and limited information available on which to base a decision. The second are *platform risks*. These risks relate to the platforms' business model, and include the potential for conflicts of interest, the impact of platform failure particularly where they hold or administer client assets and the risk that investors over-estimate the due diligence carried out. Against these risks, which are not trivial, are the supposed (but as yet untested or demonstrated) economic benefits: as ESMA 2015 expresses it, because crowdfunding has the potential to improve access to finance for the real economy and to widen the investment opportunities available to non-institutional investors, there is also an opportunity cost if the development of the industry is unduly restricted.

Conclusion and Recommendations

Care must be taken to prevent platforms from triggering an overzealous regulatory response. This means extra attention must be taken to explain risks to unaccredited investors. For example, a recent study conducted by the UK Financial Conduct Authority noted that the material on some of the platforms was misleading, especially in terms of how shares would be treated in the event of a buyout. The platforms implied equal treatment when in fact they would be diluted in the event of a VC round. They also noted that many of the negative comments submitted by platform participants were taken down while positive ones were left up, creating a positive bias. This issue will become more important as crowdfunding grows.

It is also suggested that platforms adopt the "all-or-nothing" model as this can protect investors from over-optimistic bets if other more rational investors have not joined in. It also makes fundraisers choose more realistic goals, which can prevent over-valuation and accommodate future fund raising rounds (Tomczak and Brem, 2013; Bradford, 2012). However, given the 'momentum' aspect of crowdfunding, it is important that the public sector does not co-invest through any type of vehicle on a crowd investment. Naïve investors might perceive this as a form of guarantee. The diminished role for passive public co-investment is another disadvantage of crowdfunding vis-a-vis angel investing.

Over-valuation can be mitigated by reviewing the current practice where entrepreneurs value their campaign at the beginning. This is becoming increasingly problematic given the difficulty in measuring things like IP and market size. Suggested solutions include either allowing flexibility in the amount of equity offered over the course of the campaign, or instead allowing potential funders to bid on a set amount of equity (De Buysere, 2012). Another encouraging practice already adopted by some platforms is the provision of training on how to value a business, using ex–investment bankers, fund managers and venture capitalists (Collins and Pierrakis, 2012).

The crowdfunding platform Seedrs offers a potential solution to the problem of frustrated initial investors in the event of down round. They create a nominee structure where Seedrs acts as the sole legal representative to ensure voting right changes are transparent (Palmer, 2015). Squareknot offers a similar service, while platforms such as ShareIn and Syndicate Room leave it to the company and investors to manage the post-investment processes (LINC, 2014). A widely accepted proxy advisor/ voting system would also help mitigate costs for funded companies. It potentially makes it more difficult to obtain follow on capital though.

A way to forestall potentially crippling regulation would be for platforms to work on standardizing risk measures. This would also help lessen the difficulties in ensuring adequate investor education. Standardization should also occur at a policy level. For instance, De Buysere et al. (2012) suggest that rules, preparation and approval procedure for sub -€5 million offerings be harmonized in the European Prospectus Directive to equalize compliance costs between countries. They also call for the European Commission to offer an exemption or light license to crowdfunding platforms with respect to reclaimable funds, as long as funds are separated from the platforms' funds in case of bankruptcy.

It is important that individual country legislation removes restrictions on the types of share allowed, especially in the anticipation of future dilution of the company's funders. Many start-ups need to be able to issue preferred shares or convertible bonds if they are to attract follow on financing. What would also help achieve this would be the scrapping of maximum investment limits for accredited investors (De Buysere et al. 2012). A last concern relates to aggregate subscription limits. Although intended to protect the naive investor, they have the unwelcome result of reducing portfolio diversification and increasing risk (Khlon, Hornuf and Schilling, 2015).

Who then is crowdfunding for? "These data appear to support the premise that [equity] crowdfunding may respond primarily to the needs of small start-ups that do not manage to access bank finance, or who do not need the larger sums available from venture capital or business angels" (LINC, 2014:12). This could include a small lifestyle firm, or one with a tangible consumer product that needs the marketing/ consumer feedback aspect of crowdfunding as a form of beta testing. It is not appropriate for firms where business information is too sensitive to be shared with a large number of potential investors, nor those which require substantial amounts of follow on financing (OECD, 2015). This represents a public policy and economic development challenge: "Development Agencies need to ensure that any engagement with crowdfunding is in support of their strategic economic development strategies, and that they are not diverted from these by inappropriate hype, popular mis-understanding of the realities of the economic impact of crowdfunding or the vested interests of platform operators." (LINC, 2014: 66). However, within these parameters and with sensible policy implementation, equity crowdfunding can play a useful complement to the role of business angels in innovation finance.

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